United States Department of the Interior

MINERALS MANAGEMENT SERVICE
Washington, DC 20240

SEP 18 2003

The Honorable Michael B. Enzi
United States Senate
Washington, D.C. 20510

Dear Senator Enzi:

Thank you for your letter dated July 7, 2003, requesting a status report and explanation of reasons for the decisions to revise the Minerals Management Service (MMS) Federal oil and gas valuation rules. I appreciate your providing me with the letter you received from Wyoming Governor Freudenthal regarding the proposed changes to those rules. I certainly share his concern and yours about ensuring any change in these rules do not have a negative impact on Wyoming and the State's share of royalties.

As Governor Freudenthal indicated in his letter, this past spring MMS announced that it was holding several public workshops on both the Federal oil and gas valuation rules. Prior to announcing these workshops, we contacted your staff and staff from our Senate and House authorizing and appropriations committees to inform them of our plans and to offer them briefings. I was also very pleased to have had the opportunity to meet with some of the Western Governors, including Governor Freudenthal, to discuss our plans for seeking public input on these rules.

Like most Federal agencies, MMS continually evaluates the effectiveness and efficiency of its rules. Adding clarification and simplicity to the existing rules will reduce litigation, assure more contemporaneous compliance, reduce administrative costs to the Federal Government and lessees, and make Federal lands more attractive for development and leasing. We identified certain technical issues, both for crude oil and natural gas, that we believe warrant consideration and public comment. Following is a brief summary of the issues we are considering and why, for each of the two rules:

<u>Federal Crude Oil Valuation Rule</u>

The MMS promulgated the current rule for valuing crude oil produced from Federal leases in June 2000. Our experience thus far has shown that the 2000 Federal oil valuation rule has ensured a fair return on Federal resources and generally served MMS, the states and the producing industry well. The technical issues we are considering concern primarily which published market prices are most appropriate to value crude oil not sold at arm's length and what transportation deductions we should allow. Through our experience in taking and selling royalty-in-kind (RIK) oil and information learned

CS

during litigation challenging the 2000 rule, we have identified certain items that would help to clarify the rule while maintaining the overall basic concepts and principles of the rule.

Federal Gas Valuation Rule

The rule for valuing natural gas produced from Federal leases has been in place since March 1988-over 15 years. However, in 1998 some amendments to this rule took place. In general, this rule seems to serve all stakeholders well, but our current review indicates minor changes may be needed.

At the workshops held this spring, we had excellent participation from the states, tribes, and the oil and gas industry. We were very pleased to have representatives from Wyoming participate in each of the workshops. Based on the input received, we decided to proceed with proposed rules seeking public comment for Federal oil and gas valuation. We published the proposed Federal oil valuation rule on August 20, 2003, and anticipate publishing the proposed Federal gas valuation rule this fall. Both rules will contain detailed analyses of the royalty impact to the states, the Federal Government, and the oil and gas industry. Comments on the proposed Federal oil valuation rule are due by September 19. We strongly encourage Wyoming to provide written comments on both of these rules.

Governor Freudenthal provided you with a number of specific comments for which I have provided a detailed response in the enclosure to this letter. If you would like to discuss any of these issues further, please do not hesitate to call me at (202) 208-3500.

Sincerely,

Johnie Burton

R. M. "Johnnie" Burton
Director

Enclosure

Enclosure

Response to Governor Freudenthal's Specific Comments on the Federal Oil and Gas Valuation Rules

Transportation deductions

Governor Freudenthal:

1) "The current regulations under CFR §§206.110, 206.111, and CFR §§206.156, 206.157 already determine the allowable transportation cost deductions. The CFR adequately defines such cost and covers all necessary cost deductions. MMS should not allow any indirect deductions for transportation. Most of the deductions being discussed are relabeled marketing costs, and MMS has a long-standing policy of not allowing either direct or indirect marketing costs. There is no reason to change the detailed transportation allowances as currently set out."

Response:

The MMS does not intend to modify its long-standing policy of not allowing as a deduction from gross proceeds the costs of placing production in marketable condition or costs of marketing production including indirect, internal costs.

For the proposed Federal oil valuation rule, we are soliciting comments on providing a specific list of allowable and nonallowable transportation deductions, similar to what we did in the amendments to the gas transportation allowance rule in February 1998. Our intent is to promote greater clarity and simplicity for paying royalties. At the workshops we held on the Federal oil valuation rule, we heard general support from industry and state participants for providing a list of allowable and nonallowable transportation costs to help to clarify accounting methods and streamline audit procedures.

Rate of return

Governor Freudenthal:

(2) "The rate of return was a hard-fought compromise between industry and the MMS – in which the MMS prevailed. There is, again, no reason to change the current rate, add any factor or otherwise reopen this issue."

Response:

As you are probably aware, the producing industry filed a lawsuit challenging several of the provisions in the 2000 Federal oil valuation rule (Independent Petroleum Association of America v. Baca, Civil No. 00-761 (RCL) (D.D.C.), and American Petroleum Institute v. Baca, Civil No. 00-887 (RCL) (D.D.C.) (consolidated).) That lawsuit is still pending.

Among the challenged aspects of that rule is whether the Standard and Poor's BBB corporate bond rate is sufficient as an average rate of return on transportation capital investments. The 2000 rule also eliminated the exception allowing lessees to use tariffs filed with FERC as a transportation allowance in lieu of calculating actual transportation costs. Consequently, after June 1, 2000, calculation of actual costs, including a rate of return, was required of all lessees who did not have arm's-length transportation arrangements. The judicial challenge to the 2000 rule is one of the factors that led MMS to reconsider whether BBB is a sufficient rate of return.

When MMS promulgated regulations to value geothermal resources in 1992, MMS believed that the return on capital needed to properly compute a deduction for the costs of generating electricity should be the weighted average of the returns to equity and debt (without considering income tax treatment). That led MMS to determine that two times the BBB rate was appropriate for that calculation.

The MMS has examined some rates of return in the oil industry and believes that some weighted average rate of return considering both equity and debt is appropriate as an actual market-based cost of capital. MMS believes that establishing a uniform rate of return on which all parties can rely is preferable to the costs, delays, and uncertainty inherent in attempting to analyze appropriate project-specific or company-specific rates of return on investment. That is why at the public workshops, we requested public comment on possible multiples of the Standard and Poors BBB bond rate as a measure of the oil and gas pipeline industry's cost of capital. In the published rule, MMS is asking for comments on a rate of return of 1.5 times the Standard and Poor's BBB rate.

The potential for encouraging infrastructure development among pipelines and thereby increasing income to the states is also a consideration in our decision to reopen the discussion on this issue. We have estimated that for each one-tenth increase in the bond rate multiplier, there is a $750,000 decrease in royalties per year most of which is attributable to offshore royalties.

Affiliate downstream valuation

Governor Freudenthal:

(3) "We emphasized upfront that, if companies have affiliate sales which lead to an arms-length, downstream sale by their affiliate, the downstream sales price should remain the basis for royalty payments."

Response:

The technical changes that MMS is considering for the Federal oil valuation rule do not alter the basic structure or underlying principles of the June 2000 rule. Under that rule, a lessee producing from Federal leases in the Rocky Mountain Region that sells its production to an affiliate must elect for a 2-year period to pay royalties on either the affiliate's arm's-length resale price or one of four benchmarks. We are not proposing to change that aspect of the rule.

Governor Freudenthal:

(4) "NYMEX could be used for valuing all crude oil, where the use of an index is appropriate. Using the calendar month, rather than the trading month, would simplify its use. NYMEX is widely referenced by traders and representatives and is reflective of the market.

NYMEX is less susceptible to manipulation than price surveys, as we have seen recently in some well publicized cases. The sweet crudes of southwestern Wyoming frequently have a NYMEX plus differential. The demand of the Salt Lake City refineries have a positive influence on regional differential, such that the preference for southwestern sweet crude results in a selling price greater than NYMEX (i.e., NYMEX P+). In these situations, the differential will be positive. Differentials should only be allowed if they are reasonable and actually incurred – in other words, no theoretical costs, only actual reasonable cost."

<u>Response:</u>

For crude oil not sold at arm's length, the 2000 Federal oil rule provides for the use of spot prices at defined market centers published in approved publications as the basis for valuation of crude oil for most of the country except the Rocky Mountain Region. (In the Rocky Mountain Region, spot prices are the basis for the third "benchmark.") Our experience with the rule and comments we have received lead us to believe, like the Governor, that New York Mercantile Exchange (NYMEX) futures prices may represent a more reliable and better assessment of current oil values than spot prices. But making that change will require us to revise the 2000 Federal oil rule; the Governor seems to agree with the change we are proposing.

Under the 2000 rule, market center index prices are adjusted to determine the value of production at the lease through location and quality differentials and deduction of actual transportation costs.

Lessees derive location and quality differentials from their own arm's-length exchange agreements or, if exchanges are not at arm's length, through MMS approval. In some situations, these differentials are positive numbers. Also, under the rule, lessees determine the actual transportation costs from the lease to a market center or intermediate exchange point according to whether transportation arrangements are arm's length or non-arm's length. We are not proposing to change these aspects of the rule.

Disallowing cost to place gas in marketable condition

Governor Freudenthal:

Again, the administrative precedent is to resist and deny deductions for converting gas to a marketable condition. Wyoming federal coalbed methane production should be valued at a point consistent with applicable CFR's, controlling federal law, IBLA decisions and MMS's own payor handbook – and that point is the outlet of the processing plant.

Despite administrative history, MMS initially proposed to value the gas after the Bureau of Land Management's royalty measurement point.

There is not a market pipeline in the country that would accept gas at the wetness and pressure of the coalbed methane gas after the BLM's royalty measurement point. There would be no need for a processing plant if the market pipeline would accept the gas in the condition it is in before entering a processing facility. The costs associated with compressing the gas to market pipeline pressure, dehydrating it and removing the CO_2 should not be deducted from the value used to calculate federal royalty.

The consequence of selecting a valuation point other than the processing facility outlet would be disconnecting royalty determination from a practical touchstone. That could result in the loss of millions of dollars in federal royalty revenue – and, in turn, valuable services – for the people of Wyoming and the United States.

Response:

The Governor is referring to an issue involving the valuation of coalbed methane produced from the Powder River Basin in Wyoming. We have received input from the Wyoming Department of Audit in evaluating this issue. Our analysis is not yet complete. Please be assured that we have no intention of changing our long-standing policy requiring Federal oil and gas lessees to put gas into marketable condition and to pay royalty on the value of the gas in marketable condition. We will communicate our policy decision to states having coalbed methane production as soon as the decision is final.

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
Washington, DC 20240

AUG - 4 2003

The Honorable Michael Enzi
United States Senate
Washington, D.C. 20510

Dear Senator Enzi:

Thank you for your letter dated July 7, 2003, requesting a status report and explanation of reasons for the decision to revise the Minerals Management Service's (MMS) oil and gas valuation rules.

The MMS is currently in the process of preparing a detailed response to the issues the Wyoming Governor has raised, and we will provide you with our response in the near future.

If you have any questions, please call me at 202-208-3500 or call Lyn Herdt, Chief, MMS, Office of Congressional Affairs, at 202-208-3502.

Sincerely,

R. M. "Johnnie" Burton
Director

cc: OCA

Minerals Management Service
Correspondence Actions Tracking System

CONTROL SLIP FOR: ODM-3-1284
ExecSec Number:
Surname: OCA
Resp Office: ADMRM

RecDate: 07/17/2003
CorrDate: 07/07/2003

Date Due: 07/29/2003
CorrType: DIRC

	Title/Organization	Last Name	First Name
To:	DIR., MMS		
From:	U.S. SENATE	ENZI	MICHAEL B.

Thru:
Subject: REASON FOR THE DECISION OF THE MMS TO REVISE THE AGENCY'S OIL & GAS VALUATION RULE

Comments:
For Signature of: DIR   Date Signed:

Date Rec	Assigned To	Action Req.	DateSent	Date Due Back
07/17/2003	ADMRM			

Comments:

Date Rec	Assigned To	Action Req.	DateSent	Date Due Back
07/17/2003	ODM	RESPOND	07/17/2003	07/29/2003

Comments:
RESPONSE DUE 07/31/2003

OFFICES:
Gillette 307-682-6268
Cheyenne 307-772-2477
Casper 307-261-6572
Cody 307-527-9444
Jackson 307-739-9507
D.C. 202-224-3424
email senator@enzi.senate.gov
website enzi.senate.gov

United States Senate
WASHINGTON, DC 20510-5004

MICHAEL ENZI
WYOMING

COMMITTEES:
Banking, Housing, and Urban Affairs
Health, Education, Labor, and Pensions
Foreign Relations
Small Business
Budget
Special Committee on Aging

July 7, 2003

Director of MMS Johnnie Burton
1849 C St NW Mailstop 4230
Washington, D.C. 20240

Dear Johnnie:

The purpose of this letter is to request a status report and explanation of reasons for the decision of the Minerals and Management Service (MMS) to revise the agency's oil and gas valuation rule.

For your convenience I have enclosed a copy of a letter sent to me by Wyoming Governor Dave Freudenthal regarding proposed changes to the rule. Governor Freudenthal has carefully articulated his reasons for opposing these revisions. I share his concerns about ensuring that any change in this rule does not have a negative impact on Wyoming and the state's share of royalties.

Thank you in advance for your consideration. I look forward to your reply.

Sincerely,

Mike Enzi

Michael B. Enzi
United States Senator

MBE:ds

DAVE FREUDENTHAL
GOVERNOR

THE STATE OF WYOMING

STATE CAPITOL
CHEYENNE, WY 82002

Office of the Governor

June 13, 2003

Honorable Mike Enzi
U.S. Senator
Russell Senate Building
Washington, D.C. 20510

Dear Senator Enzi:

I hope all is well with you in Washington.

We have had the pleasure of working with the Interior Department's Minerals Management Service as partners on a range of important issues of concern to the state of Wyoming. Our partnership, which was encouraged by the 1996 Federal Oil and Gas Royalty Simplification and Fairness Act, has been particularly beneficial with regard to oversight of the federal royalty collection program.

However, the MMS recently announced several initiatives that have potentially serious impacts on the amount of royalty revenues received by the federal government and numerous Western states, including Wyoming.

These initiatives indicate that MMS is considering changes to a number of long-standing policies, in light of recently held workshops to reconsider several aspects of rules for federal and oil and gas valuation. Some of the changes being considered could be a reversal of policies that are now in place. The state has also received indications from MMS that the service could reverse its policy of disallowing costs to place gas in marketable condition for coal bed methane production.

The U.S. Department of the Interior has gone to court and prevailed on this issue for more than half a decade – we see no need to change the policy now.

Oil and gas valuation rule

We agree with the MMS that both the oil and gas rules "are working well and accomplishing (their) objectives." Never has the old adage "If it ain't broke, don't fix it" held more true. And yet, the MMS is considering some of the following changes:

1) The current regulations under CFR §§206.110, 206.111 and CFR §§206.156, 206.157 already determine the allowable transportation cost deductions. The CFR adequately defines such cost and covers all necessary cost deductions.

TTY: 777-7860 PHONE: (307) 777-7434 FAX: (307) 632-3909

MMS should not allow any indirect deductions for transportation. Most of the deductions being discussed are relabeled marketing costs, and MMS has a long-standing policy of not allowing either direct or indirect marketing costs. There is no reason to change the detailed transportation allowances as currently set out.

2) The rate of return was a hard-fought compromise between industry and the MMS – in which the MMS prevailed. There is, again, no reason to change the current rate, add any factor or otherwise reopen this issue.

3) We emphasized upfront that, if companies have affiliate sales which lead to an arms-length, downstream sale by their affiliate, the downstream sales price should remain the basis for royalty payments.

4) NYMEX could be used for valuing all crude oil, where the use of an index is appropriate. Using the calendar month, rather than the trading month, would simplify its use. NYMEX is widely referenced by traders and representatives and is reflective of the market.

   NYMEX is less susceptible to manipulation than price surveys, as we have seen recently is some well publicized cases. The sweet crudes of southwestern Wyoming frequently have a NYMEX plus differential. The demand of the Salt Lake City refineries have a positive influence on regional differential, such that the preference for southwestern sweet crude results in a selling price greater than NYMEX (i.e., NYMEX P+). In these situations, the differential will be positive. Differentials should only be allowed if they are reasonable and actually incurred – in other words, no theoretical costs, only actual reasonable cost.

There is no need to revise either current gas or oil rules at this time. The proposed changes to the rules would only increase the industry's ability to reduce royalty through ever-expanding deductions. This may result in a loss of royalty revenue for the people of Wyoming, as well as other Western states and the federal government.

Disallowing cost to place gas in marketable condition

Again, the administrative precedent is to resist and deny deductions for converting gas to a marketable condition. Wyoming federal coalbed methane production should be valued at a point consistent with applicable CFRs, controlling federal law, IBLA decisions and MMS's own payor handbook – and that point is the outlet of the processing plant.

Despite administrative history, MMS initially proposed to value the gas after the Bureau of Land Management's royalty measurement point.

There is not a market pipeline in the country that would accept gas at the wetness and pressure of the coal bed methane gas after the BLM's royalty measurement point. There would be no need for a processing plant if the market pipeline would accept the gas in the condition it is in before entering a processing facility. The costs associated with compressing the gas to market pipeline pressure, dehydrating it and removing the CO_2 should not be deducted from the value used to calculate federal royalties.

The consequence of selecting a valuation point other than the processing facility outlet *would be disconnecting royalty determination* from a practical touchstone. That could result in the loss of millions of dollars in federal royalty revenue – and, in turn, valuable services – for the people of Wyoming and the United States.

The state will continue to work with our counterparts in federal government to ensure that the people of Wyoming will receive their fair share of federal mineral royalties. Please join in the effort to make certain our constituents receive the royalties to which they are entitled.

Best regards,

Dave Freudenthal

Dave Freudenthal
Governor

DDF:MG:la
CC: Sen. Craig Thomas, Rep. Barbara Cubin, Audit Director Mike Geesey, file